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SIPDIS

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SUBJECT: UK COURT RULES ON DONEGAL "VULTURE FUND"

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05 LUSAKA 603

11. (SBU) SUMMARY. On February 15 a UK judge ruled that the Government of Zambia is liable for a debt owed to Donegal, a British Virgin Islands-based investment fund that is partly owned by a U.S. company. Although the ruling received much negative publicity in the international media, some Zambian Government officials viewed it positively, primarily because the ruling suggested that Zambia will not be liable for accrued interest on the outstanding debt. They are also pleased that the case has exposed corruption surrounding the Donegal deal and has raised public awareness of--and aversion to--"vulture fund" practices. END SUMMARY.

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Background  
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12. (SBU) In 1979 the GRZ borrowed approximately USD 14 million to purchase Romanian tractors but subsequently failed to service the debt. In December 1998, the GRZ negotiated an agreement with the Romanian government to liquidate the debt for USD 3 million. Before this arrangement could be completed, Donegal International purchased the non-performing debt for USD 3.2 million (approximately 11 percent of its face value). There were allegations that the British Virgin Islands-based Donegal, which is partly owned by a U.S. company, Debt Advisory International, engaged in corrupt practices to secure the deal (Ref C).

13. (SBU) In 1999, the value of the unpaid principle plus interest (accruing at an annual rate of 8 percent) was USD 29 million. According to a settlement agreement that the two parties reached in London in early 2004, Zambia agreed to pay Donegal USD 42 million, reflecting a balance of USD 29 million plus an additional USD 13 million in accrued interest. Allegedly the agreement also stipulated that in the event of a dispute, the matter would be litigated in UK courts.

14. (SBU) However, in March 2004, after the Task Force on Corruption found evidence of fraud in Donegal's acquisition of the claim, the GRZ stopped servicing the debt (Ref B). Donegal subsequently launched a civil case in the UK, suing the GRZ for the outstanding balance. Donegal also applied to the UK courts for an injunction, freezing about USD 50 million in Zambian government assets.

15. (SBU) The court case began in February 2006 in a UK civil court and ran through July 2006 (Ref A). DLA Piper, the UK law firm representing the GRZ, built its defense on the contention that Donegal acquired the debt through fraud and therefore had no claim against the GRZ. The legal team--led by William Blair (Prime Minister Tony Blair's brother)--provided evidence on a series of bribes, including one to former President Chiluba, that were used to acquire the debt as well as to facilitate Zambian payment on the debt.

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The Ruling  
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¶16. (SBU) On February 15, a UK judge ruled against the GRZ's application to dismiss Donegal's claim. The judge, Andrew Smith, reportedly found Donegal's actions to be "reprehensible but not illegal." Nevertheless, he proposed to end a freeze of Zambia's assets secured by the fund, and indicated that Zambia would not be liable for the entire outstanding amount (which by 2007 had reached USD 55 million, according to Donegal's calculations), but rather would be required to compensate Donegal for the original debt (USD 14 million) plus damages. Embassy contacts estimate that "damages" will include some legal fees, less the USD 2.2 million that Zambia already paid to Donegal. The total is likely to be between USD 10 and 20 million.

¶17. (SBU) The case will reconvene on March 9, and a final ruling on Zambia's liability is expected in April. Embassy contacts point out that there is no precedent in UK courts and that it is possible that Judge Smith will further reduce Zambia's liability. They also speculate that Judge Smith has little sympathy for Donegal, whose witnesses the Judge reportedly found to be "dishonest and deliberately evasive."

¶18. (SBU) A representative from the Attorney General's office and other informed sources told P/E officer that they viewed the ruling positively because it has exposed the corruption behind the Donegal deal, and because it has raised public awareness of--and aversion to--so-called "vulture funds" (companies that buy debts of poor nations at reduced rates, and then sue for the full value of the debt plus interest). They expressed relief that Zambia would not be liable for the unpaid interest, which by 2007 has dwarfed the original loan amount. They also opined that the Donegal case was

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the most challenging of the three high-profile Zambian cases before UK civil courts (Ref A).

¶19. (SBU) A representative from the UK's Department for International Development (DFID), which has provided substantial budget support to the Task Force on Corruption, told P/E officer that DLA Piper attorneys were "delighted" by the ruling. She also described as "ridiculous" media reports that attempt to link the Donegal ruling to debt relief. (NOTE: A local consultant to Oxfam has made this link, which has reverberated in international media. END NOTE.)

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COMMENT  
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¶10. (SBU) In 2006, Zambia benefited from almost USD 3.9 billion in debt relief. Those who claim that Zambia's Donegal liability is somehow equal or comparable to 2006 debt relief are hugely mistaken. The liability is perhaps more easily likened to Zambia's anticipated 2007 foreign debt service of USD 34 million (compared to a pre-debt relief figure of USD 373 million).

¶11. (SBU) In many ways the ruling could be considered a small victory to the Task Force on Corruption, insofar as the Task Force succeeded in exposing the shady dealings behind the Donegal debt agreement, and inasmuch as its UK attorneys succeeded in reducing Zambia's liability. Zambia's liability, however, is still likely to be larger than the amount that had been agreed upon with the Government of Romania in 1999. Unfortunately, much of the local media coverage has lacked clarity and has focused on the liability, rather than the alleged corruption that surrounded the Donegal deal. Attempts in the local and international media to make linkages to debt relief (an entirely unrelated matter) only muddy the waters further by making the issue about poverty rather than corruption.

MARTINEZ